So the good news is that now we have finally learned to be more realistic…right? Wrong. Even after the collapse of the mortgage market, people still don't understand how home prices are influenced by government policies. And so while the Bush and Obama administrations have committed massive amounts of government resources to prop up the deflating market, people still don't recognize how these trusses are simply extending the pain and setting us up for an even bigger fall.

CHAPTER 15

THE HUT RUT



It's hard to say when the market first turned. Perhaps it was the high-profile demise of the Crater View Condominium Huts, which, despite their amenities, ample square footage, and unmatched ocean and lava views, somehow failed to attract buyers.


CRATER VIEW CONDOS
UNITS AVAILABLE!
OPEN HUT

As Manny Fund was the principal underwriter of the project, the investment company took a big hit when the developer defaulted on the construction loan. When nervous real estate investors saw the losses at the Crater View Condos, many of them took a hard look at some of their other risky real estate holdings. A distinct apprehension began to spread.

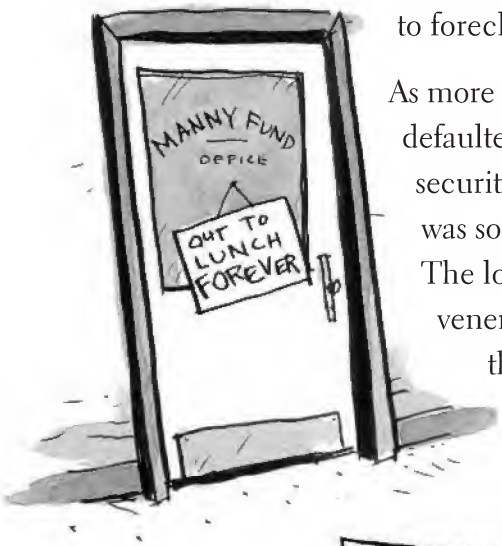
Soon, buyers—both large and small—figured the market had peaked. Many decided that they should sell their current properties, take their frothy profits, and wait for a more favorable time to reinvest.

There was just one problem—everyone was thinking the same thing at the same time. Most of the owners in the market never intended to hold their properties very long to begin with. So when the market began to turn, everybody wanted out. In short order, the island was awash with sellers and devoid of buyers. When that happened, the unthinkable occurred—prices didn't just decline in a modest, orderly fashion…they started plummeting. The hut glut had quickly turned into a massive hut rut.

Suddenly, hut ownership, once a surefire ticket to easy wealth, became a decidedly riskier proposition. With prices no longer rising, huts did not create any fish equity to extract and profits from quick resales were no longer possible. With the pot of gold no longer looming at the end of the rainbow, uncomfortably high loan payments became a burden hardly worth bearing

This situation was further complicated when temporally low introductory teaser rates reset higher, which made the

homes instantly unaffordable for those borrowers whose only hope had been a quick resale or fish-traction. With homes worth less than their underlying loans, the temptation to walk away from big payments became intense. This was especially true for those who did not put any fish down at purchase. Having made no prior commitment of funds, these borrowers had nothing to lose by not paying their mortgages and allowing the bank to foreclose.



As more and more borrowers defaulted, Manny Fund's securitized loan business was soon declared bankrupt. The losses overwhelmed the venerable institution. Shortly thereafter both Fishy and Finnie admitted that they too were belly-up.



With consumers no longer extracting hut equity, the industries that grew up around the hut glut also fell into crisis. Hut builders, design consultants, window trimmers, and appliance salespeople werelaid off in droves.

Other seemingly disparate industries were impacted as well. The Usonian donkey cart makers had benefited greatly from hut equity extractions. Effortlessly pulling fish out of their appreciating huts had allowed islanders to buy bigger and bigger carts. In the go-go days, many of these wagons became so large that four or five donkeys were needed to pull them. (This was problematic as most of the donkeys were imported.) With no more hut equity to tap into, sales of these "grass guzzlers" plummeted, and the cart companies fell into bankruptcy.

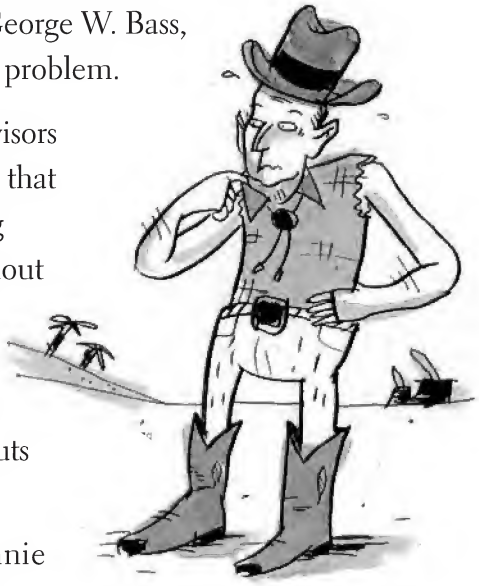


The island became ensnared in the worst economic crisis since the great monsoon of Franky Deep's era. Growing desperate, the unemployed workers converged on the Senate demanding solutions.



Stimulus to the Rescue

After years of denying any weakness in the economy, the island's Senator-in-chief, George W. Bass, belatedly set to work fixing the problem.



With strong unanimity, his advisors recommended bold incentives that would get consumers spending again, especially on huts. Without any understanding of why savings and production fuel economic growth, the Senate decided on a program of bailouts and stimuli.

Their first rescue was for Finnie and Fishy, which were taken over by the Senate directly and were stocked with new Fish Reserve Notes to cover their losses. The reorganized

companies were ordered by their new management (the Senate) to offer ultra-low-rate hut loans to anyone who had the wherewithal to fill out an application.

It was hoped that the continued availability of easy credit would increase demands for huts, and thereby stop the slide in prices.



When these policies failed to stem the fall, Bass called an emergency meeting of his top advisors, including Ben Barnacle, who had previously assured him that prosperity would be endless.

"Hey, Barney," said the Senator-in-Chief in his trademark folksy demeanor. "You sure sold me a bill of goods on this one. I thought this economy thing was supposed to be simple. You know, they make 'em, we eat 'em, and everyone gets a hut or two! I mean how do we get the shark to smell the chum on this one?"



The other senators searched for the meaning of his metaphor. Perhaps none existed.

"Well, sir, the problem is quite simple," said Hank Plankton, the new head fish accountant. "Hut prices are falling, so citizens don't feel as wealthy as they did before. As a result, they have stopped spending. If we can push hut prices back up, people will start spending again."

"Cool, Plankie, I knew this was gonna be a breeze," said Bass. "How we gonna do that? Do we have someone in charge of that? Sounds like a cool job. Maybe I'll appoint one of my biggest donors."

"Well, sir, it's not quite that simple," said Plankton. "We can't just mandate that hut prices go back up. As you know, we have kept Finnie and Fishy lending. Unfortunately, that alone is not enough. For some reason the people don't want to borrow. Perhaps the loan application is still too complicated. But for now, we need to push interest rates lower and then give people more tax breaks to buy huts. That should create a lot of demand for loans, which should stop hut prices from falling and get hut builders busy again."



✔ REALITY CHECK

The last thing the island needed was more huts. There were already too many huts. Any energy or resources spent building more huts would be wasted.

Similarly, hut prices were still too high. They had been bid up to ridiculous levels by a combination of factors that would never return. Trying to keep them from falling was like trying to keep a bridge from collapsing after all the supports had been knocked away.

Despite the fact that many islanders were upset for overpaying for their huts, the island economy would actually be better off if hut prices came down and building ceased altogether, at least until real demand returned. That way people could spend less on huts and have more to spend on things the economy lacked—like new businesses and carts that could be pulled by just one donkey. Resources used for new hut construction, like bamboo and rope, could be used for new businesses instead.

Unfortunately, government interventions would prevent this natural reallocation of resources from occurring.

Plankton continued laying out his plans. "We also need to make sure that Manny Fund remains solvent. The company owes a lot of fish to a lot of people. If it were to go down, the entire island economy would utterly collapse. We also need to make sure that no one who invested in Manny Fund loses any fish. If we don't do this, I'm sure that we would all starve… especially the children."

"Well, that aint gonna happen on my watch, Plankie," replied Bass. "Tell them that we're gonna come to the rescue with a bailout. Hey, didn't you used to work there?"

"Yes, Mr. Senator, I was the president of the company. But I really don't see how that has any relevance to this conversation, and frankly, I resent the insinuation."

"Aw heck, Hank, I was just funnin," Bass continued. "Okay. After we get hut prices back up, and keep Manny and the boys in business, how are we gonna get people spending again? Where they gonna get the fish? I mean last time I checked, we were all a bit tapped in the tuna department. Isn't that why they're outside holding pitchforks?"

"Well, sir, we plan on distributing new Fish Reserve Notes to all the citizens. That should get them spending."

"That's cool. But where we gonna get the fish? Haven't our technicians stretched the sturgeons about a far as they can?"

"Well, sir, we have some new commitments from the Sinopians. They have offered to buy the Water Works system for 100,000 fish."

"Hold on honcho. Sell the Water Works? You're talking about jeopardizing our national security! They'd have me tarred and feathered for giving up something like that to those carpetbaggers. Couldn't they just make it a loan instead?"

After months of tense negotiations, Bass's ambassadors convinced the Sinopians that a sale of the Water Works was politically impossible. Instead, the Sinopians somewhat bitterly agreed to make a 100,000-fish loan.



"Hey, Hank," said Bass, after word came back of the successful outcome. "Great news, we got the loan. Just one thing.How are we gonna pay it back?"

"Well, sir, I expect that we will just print up another batch of Fish Reserve Notes. But this time we will use our very best paper."

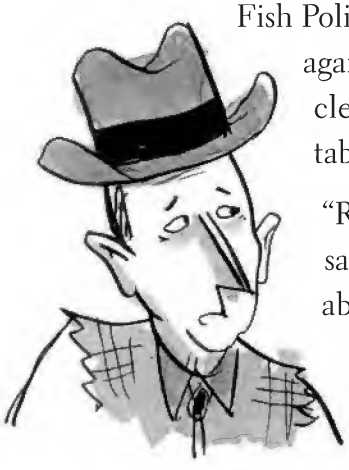


"Yeah, but what if they won't take them? Aren't we getting a lot of guff from them people already about the value of our notes? It's like that Chuck DeBongo guy a few years back. Won't they just start selling if we issue so many more notes?"

"Highly unlikely, sir. Think about how many Fish Reserve Notes they already have. If they stop taking them, those notes will lose even more value. We've got them over a barrel. And if things get dicey, we'll just remind them of our 'Strong Fish Policy!'"

"Oh, yeah. I forgot about that. It's nice having that one in your back pocket. Is that where we go out and catch more fish to back up our notes?"

"No sir," chimed Ben Barnacle. "The Strong Fish Policy is all about tone. We don't actually do anything. We just say 'Strong Fish Policy' really clearly and loudly again and again. Also, it helps if you clench your fist and beat it on the table when you say the words."



"Right you are, Barney. Let's just say I know a little something about acting tough. Mission accomplished! Now let's go surfin'!"



TAKEAWAY

It's hard to overstate the impact the housing boom made on the economy as a whole. During the height of the mania, the financing, construction, and furnishing of homes had become the central dynamo of the U.S. economy. And while everyone acknowledged the good fortune, few spared much concern about the future costs.

In addition to the profits made by real estate "flippers" (those who serially bought and sold properties), homeowners extracted hundreds of billions of dollars per year from their homes. The process turned houses into tax-free ATM machines. People used the money to renovate their homes, take vacations, pay for college, buy cars and electronics, and just generally live better than they would have if their homes had not appreciated in value.

But the wealth was simply a mirage.

In his book *Irrational Exuberance* economist Robert Shiller determined that in the 100 years between 1900 and 2000, home prices in the United States increased by an average of 3.4 percent per year (which is just slightly higher than the average rate of inflation). There were good reasons for this. Prices were firmly tied to people's ability to pay, which is a function of income and credit availability.

But from 1997 to 2006 national home prices gained an astounding 19.4 percent per year on average. Over that time incomes barely budged. So why could people pay so much? The difference was credit, which government policy made

much cheaper and easier to get. But credit could not expand forever, and eventually conditions tightened. When they did, there was nothing to hold prices up.

So when the market crested, the easy money that for years had poured into the economy stopped flowing. Even if there had been no other economic reversals that followed the housing bust (which there were), the economy would have had to shrink without all the free cash. A recession was not only inevitable but absolutely necessary to rebalance the economy.

But when the economy started to contract, lawmakers and economists treated the development not as the inevitable consequence of years of easy money and overspending, but as the problem itself. In other words, they mistook the cure for the disease.

The policy goals of both the Bush and Obama administrations have been to encourage consumers to spend as they had before the housing crash. But where will the money come from? If unemployment rose, and incomes and home prices fell, where would consumers get the money?

Economists have declared that if the people can't spend, the government needs to step up and do it for them. But the government doesn't have any money. All it has is what it collects in taxes and what it borrows or prints.

For now, this process is just creating massive public debt ($1.6 trillion per year and counting). And although the numbers look bad, we are still able to sell most of this debt on the open market, primarily to foreigners.

But our "good fortune" can't last forever. Ultimately the U.S. government will have only two options: default (tell our creditors that we can't pay, and negotiate a settlement) or inflate (print money to pay off maturing debt). Either option will lead to painful consequences. Default, which does offer the possibility of a real reckoning and a fresh beginning, is actually the better alternative. Unfortunately, while inflation is worse, it is also the more politically expedient.

CHAPTER

16

STEPPING ON THE GAS



Despite the bailouts and incentives made by Bass and Plankton, the Usonian economy continued to deteriorate during the Great Hut Rut. Strangely, no one showed much interest in buying new huts. Instead of spending their stimulus fish, some islanders elected to save them. With spending stagnant, the cart companies teetered on the edge of extinction. Hut Depot was devastated. Unemployment got worse. Public dissatisfaction intensified.

The next election proved to be pivotal. Barry Ocuda, a candidate for Senator-in-Chief, accused the Bass faction of inadequacy in the face of a national emergency. He pilloried the Bass moves as trifling half measures. Campaigning on a theme of *transformation*, Ocuda promised much greater government efforts to turn the island's economy around.


TRANSFORM

Taking power, the young Senator-in-Chief got to work, and transformed the Bass policies by tripling them in size! He devised a number of new programs to push newly printed Fish Reserve Notes into the economy.

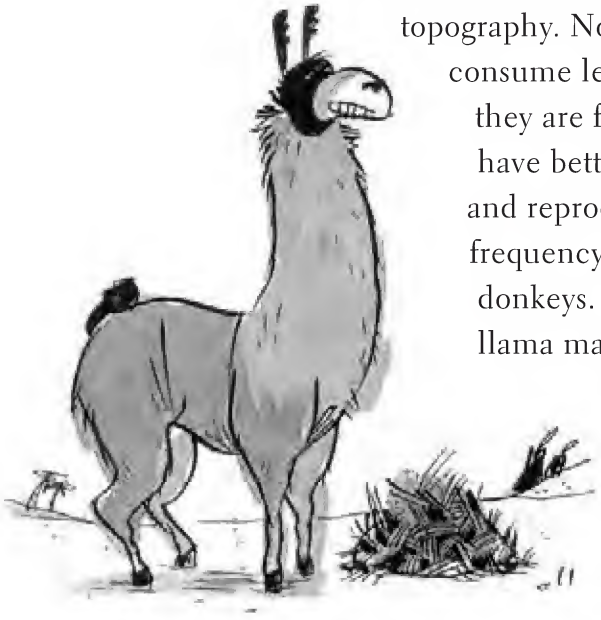
He increased the amount of assistance that the government would give to hut buyers—initially just to first-time hut buyers and then to trade-up buyers as well. And, once again, he lowered the interest rates that Finnie and Fishy charged.

Noticing that the surfing school attendance had fallen off dramatically, he increased direct aid to schools, and made student loans even easier to get.

He authorized the building of a new lighthouse at Shady Swamp. When engineers pointed out that the facility was not entirely needed, Ocuda reminded them that the construction jobs alone would provide a powerful boost to the economy.



Ocuda, also placed much faith in the need to develop alternative energy sources. He argued, "Society has become too dependent on donkeys. Llamas are far better suited to the island's climate and topography. Not only do llamas consume less grass, but they are far surer footed, have better dispositions, and reproduce with more frequency than traditional donkeys. To top it all off, llama manure is far less offensive to the senses."

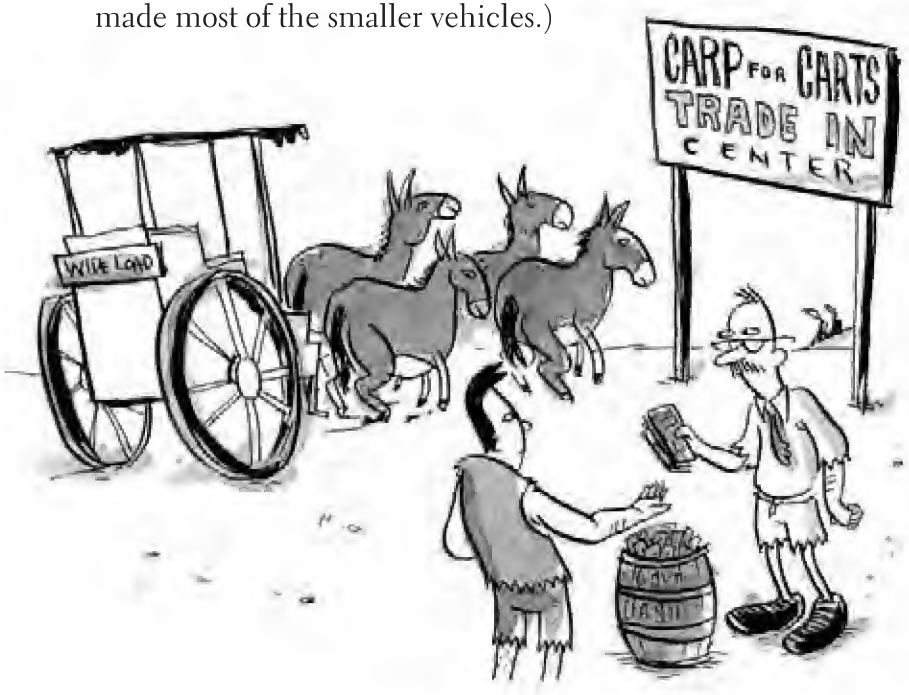




Ocuda envisioned a multistage plan to transform the old economy.

First, he would hasten the adoption of llama-based infrastructure through massive stimulus spending. To this end, he called for an aggressive state-run llama breeding program. He also mandated that manufacturers (now run by the Senate directly) redesign and refit the carts for llama use. Last, he set about resurfacing all the island's cart paths with a topsoil better suited for llama feet.

Second, Ocuda also came up with the "Carp for Carts" program, which offered government incentives to get people to turn in their grass guzzlers for more fuel-efficient carts. (This was great news to the Sinopian cart companies that made most of the smaller vehicles.)



✔ REALITY CHECK

To many, the positive impact of programs such as Carp for Carts and the jobs created by the Shady Swamp construction project, was taken for granted. It was easy to see how these ideas boosted sales and put people to work.

But as was the case with Senate-financed hut loans, it was far from certain that such spending was the most effective use of the island's resources. In fact, none of these activities did much to expand productive capacity.

Not nearly as evident were the jobs that were destroyed or not created as a result of diverting scarce labor and capital to the activities that the Senate deemed to be important enough to fund.

Through trial and error, market forces would have determined the best use for remaining investment capital. Enterprises that misread the market would lose money and investors would back away. Those that got it right would profit, attract more capital, and expand.

Perhaps efforts would have been better spent building nets, farming equipment, or canoes. The most successful ventures would have been those that most efficiently gave the people what they wanted, when they wanted it. But with the free market now apparently discredited, everyone put their faith in a small group of people to make decisions normally left to the island as a whole.

As Ocuda and his senatorial ally, Nan ShallowSea, prepared to spend piles of newly printed Fish Reserve Notes, there was one small detail that they overlooked: Usonia was completely out of fish. All their planned spending had to be financed from abroad.

Solely as a result of the willingness of foreigners to trade real goods for paper, Usonians had been able to consume more than they produced. As a result, their current choices were simple:

1. Consume less and use the savings to pay back debt.
2. Produce more and sell the extra goods to pay back debt.
3. Borrow more to continue current levels of consumption.

The first two choices involved unpleasant outcomes for Usonians. Either they would be working harder, eating less, or both. The third choice dealt all the sacrifice to foreigners. Not surprisingly, the senators courageously chose to ship the pain abroad. In so doing, they hoped the renewed spending would restore economic health at home.

✔ REALITY CHECK

But remember an economy can't grow because people spend; people spend because an economy grows. This elusive truth was lost to the senators and all their advisors. In the meantime, the newly printed notes created the illusion of improvement.

The unemployed knew that jobs were being created in Sinopia as fast as they disappeared at home. This resulted from Sinopia's Fish Reserve purchases, which pushed up the value of Fish Reserve Notes and made Sinopian products cheap and irresistible. As a result, Ocuda and ShallowSea publicly lobbied for the Sinopians to dial down their purchases, which would allow Fish Reserve Notes to lose value and make Usonian products more competitive.



Of course, no one had any idea how Sinopia could simultaneously lend the fish necessary to finance the spending envisioned by Ocuda while rolling back the Fish Reserve Note purchases that were the means of the funding. No one even bothered to ask the question. Even while they prepared to borrow more than they ever had before, the senators forgot that someone had to do the lending.

Sinopia Wises Up

On the other side of the ocean, the Sinopians were not nearly as enthusiastic about the senators' plans. Things started to get a little unsettled when the workers got wind of how many more real fish they would be asked to devote to buying Fish Reserve Notes.



Most Sinopians were frustrated with working so hard and getting so little. Since their own government did not provide the social safety nets available in Usonia, the average Sinopian saved lots of money just so they would not be hutless and fishless in old age. Everyone worked, no one had a donkey (let alone a cart), and hardly anyone surfed. Even if they did, they usually went four or five to a board.



The Sinopian king was also losing enthusiasm for the arrangement, and was particularly vexed by the staggering spending plans announced by Ocuda. His advisors, many of whom had been students of the great Ally Greenfin, began to worry that their cache of Fish Reserve Notes would lose value if they stopped buying. And if that happened, Usonians would no longer buy as many Sinopian products.

They argued that without Usonia's thunderous demand, their own export factories would shut down, causing unemployment, discontent, and perhaps even protest (which had never been allowed in Sinopia). Caught on the horns of a dilemma, the Sinopian king kept the status quo going and hoped for an answer.

One day, while he was deep in thought and his council of economic advisors was away on a research expedition, a simple peasant slipped past the palace guards and engaged the worried king in conversation.



"My most glorious leader, please forgive the intrusion, but I hear that you have been troubled by thoughts of fish. Perhaps I may be able to help."

"These are great matters involving trade, savings, investment, and planning. What can you know of such things?" thundered the king.

"Very little, I am sure," conceded the peasant. "But I know that in my village, we all make nothing but wooden bowls, which we send across the sea. In exchange, we get paper, which we save for the future. Someday we hope to buy things with the paper, but now there is little. As we send away our bowls, we wonder why we have no bowls ourselves. We still eat our fish off the floor. Most unsanitary. Would it not be simpler if we just made bowls for ourselves? In that way, our work would improve our lives."

"That's absurd," said the king. "Our people would starve without our exports. How else could we run our economy?"

"Well, my king, as I said, we are good at making bowls. And since—under your wise leadership—we are catching so many more fish, all we need is to find someone here at home who would trade their fish for our bowls. Then all of our productivity would stay here, and our people would have more bowls and more food to put in them."

The king was puzzled. "But wait, the Usonians are so much wealthier than we. How can we compete with their citizens to buy the products we make? They can afford to pay more. They have the Fish Reserve Notes."

"Begging Your Majesty's pardon, but I don't see why we need their notes. They have value only because of our fish and our bowls. We have made the products, so of course we can afford them. We just have to stop giving them away for nothing."



Somehow the simplicity of the peasant's words made a profound impression on the king and he decided to change the policy. No more purchases of Fish Reserve Notes. From now on Sinopians would trade their goods only for real fish!

Since he was uncomfortable with the fast change that the peasant seemed to advocate, the king decided on a gradual course. After all, the king had plenty of bowls, none of which were made of wood.



TAKEAWAY

As a result of a few quarters of positive gross domestic product figures, economists now tell us that the Great Recession is over. But with unemployment still more than 10 percent, and underemployment (those who have given up looking or who work only part-time) still more than 17 percent, many Americans would be surprised to hear the good news.

In truth, the Great Recession had begun the painful, but unfinished, work of rebalancing our economy. In 2009 our national savings rate ticked up for the first time in years, and our trade deficit finally began to shrink after its dizzying ascent earlier in the decade. But the Bush and Obama stimulus programs put a stop to this. The creation of ever greater quantities of debt has given us a reprieve from the process of returning to living standards commensurate with our productivity.

But at some point in the foreseeable future, perhaps in the next few years, we will have a very ugly encounter with our debt. Thus far we have dodged the bullet. Unfortunately, due to our growing annual budget deficits and the looming bankruptcies of Social Security and Medicare (caused in part by the demographic shift of retiring baby boomers), the bullets will be coming at us with much higher force and frequency.

Washington has shown absolutely no willingness to confront the problem. The ability to make significant cuts in government spending has never been considered, let alone

attempted. In the early days of his tenure, President Obama made a theatrical show of going through the $3 trillion federal budget "line by line" in order to find "wasteful spending." This resulted in a paltry $17 billion in savings, less than one-half of 1 percent of the budget. Even those proposed cuts elicited howls of protest by both Democrats and Republicans.

If our government won't impose financial discipline, then our creditors, most notably China and Japan, eventually must. Although there are many forms in which this discipline could be delivered, the most likely method is that they simply stop buying our debt.

For now they have fallen into the same trap as the Sinopians. Once they realize that the continual extension of credit to a customer that can't pay is a waste of resources, they will change course. At that point they will refocus their productivity on domestic consumers, who will then fully enjoy the fruits of their labor.

For now, despite increased grumbling and calls for international monetary reform, those nations have kept lending. But their stamina can't be everlasting.

With more than 50 percent of our government debt currently sold to foreign governments, who will pick up the slack when they stop buying? With very little domestic savings to tap into, Americans alone won't be able to do it.

When that day comes, we will have two choices: default or inflation. Both options will violently force American living standards downward through lost purchasing power and higher interest rates.

CHAPTER

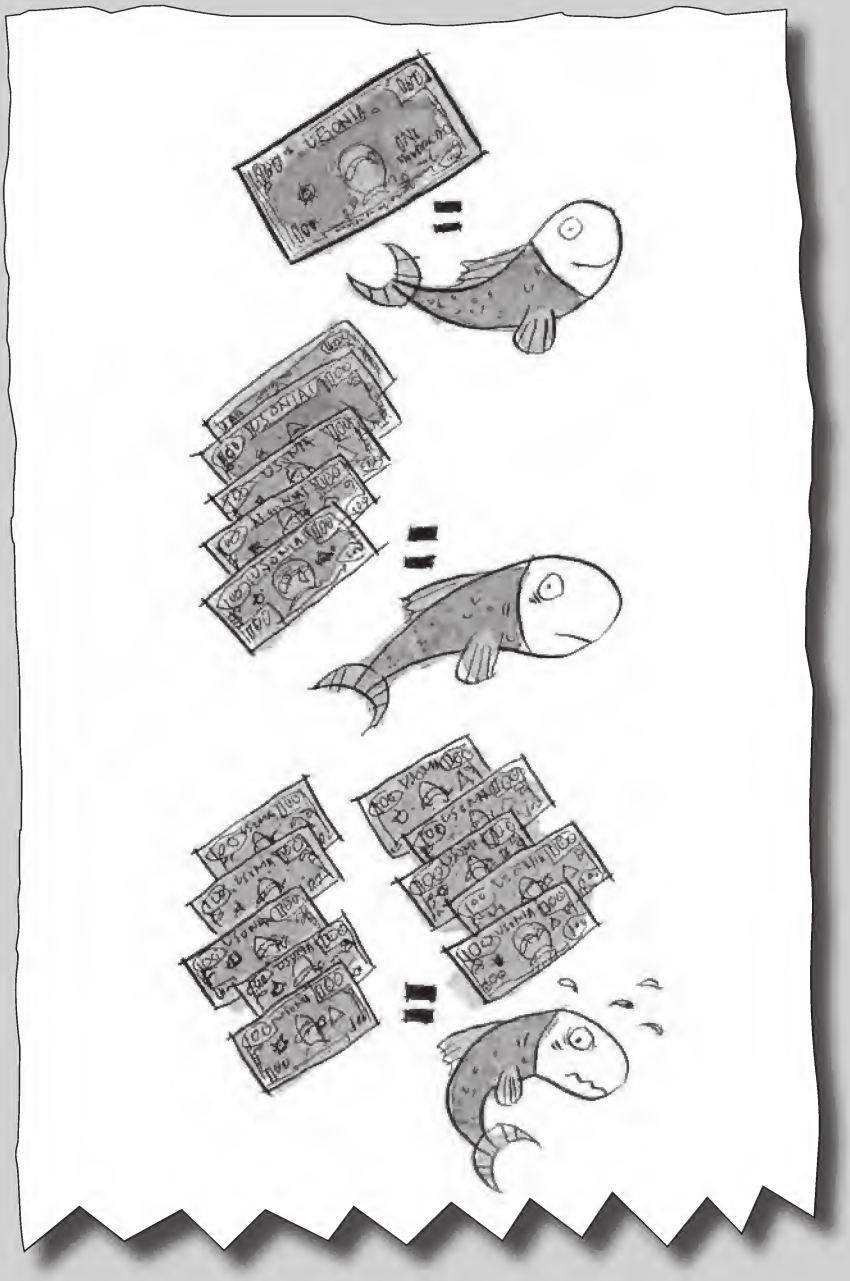
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THE FISH HIT THE FAN

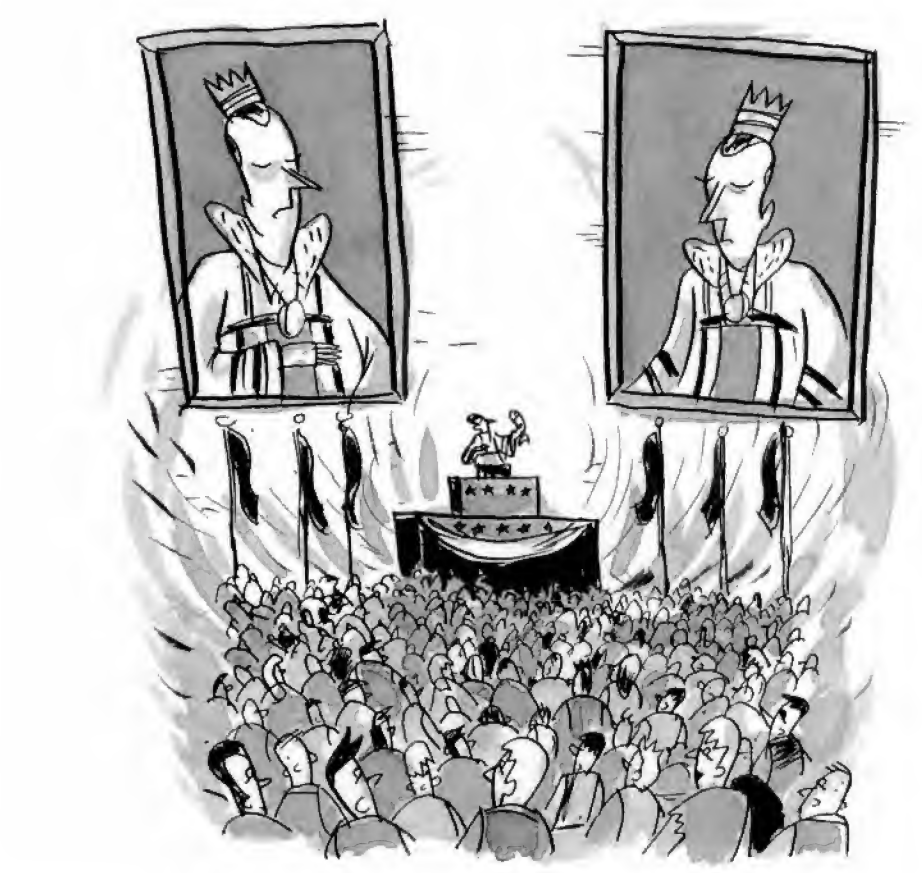


As the daily deliveries of Sinopian fish slowed, things began to change.

When the Sinopians, the biggest buyers of Fish Reserve Notes, reduced their purchases, the supply of notes began to overwhelm demand. When there is more supply then demand, prices have to fall. As Fish Reserve Notes steadily drifted downward in value, no one wanted to be the one left holding the bag. The Bongobians and the Dervishes then joined the Sinopians in limiting their purchases. With plenty of sellers and no buyers, Fish Reserve Notes entered a death spiral.



Stuck with stacks of rapidly depreciating notes that he couldn't sell, the Sinopian king realized that events had moved beyond his ability to control them. Knowing that his island's Fish Reserve Notes would soon be nearly worthless, he prepared his subjects to bite the bullet. At a mass rally he assured them that short-term pain would soon give way to long-term gain.



As expected, the value of Sinopians' savings of Fish Reserve Notes turned out to be a mirage. The Sinopian economy was pushed into disarray as some businesses closed. But as the peasant had predicted, other businesses soon stepped in

and used the spare capacity to make things the Sinopians actually needed.

As they had before, the Sinopians still caught fish, made products, and generated savings. Since these were the essential ingredients that caused an economy to grow, there was no reason for Sinopia to fall into crisis. In fact, with more products available at home and more of their savings in their own banks, living standards started to improve. Savings that in the past were locked up in Fish Reserve Notes were instead lent out to local factories to retool for domestic consumption. As more products were produced for local consumers, Sinopian stores suddenly found themselves stocked with goods. Increased inventories meant that prices could come down.



As the peasant had predicted, despite the losses in their doomed stockpiles of Fish Reserve Notes, Sinopia thrived.



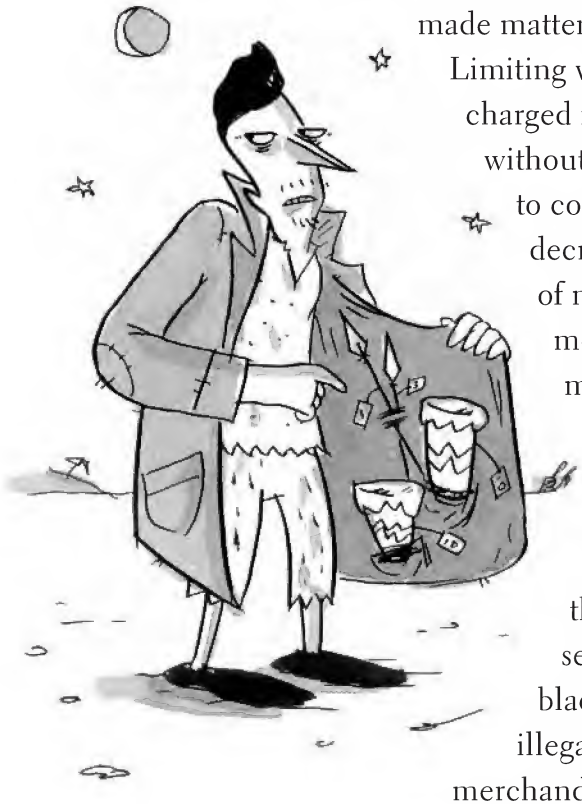
Back in Usonia things were headed in the opposite direction. With only the meager domestic catch available, the bank's fish technicians had to work harder and more creatively than ever before. Official fish began shrinking at an alarming rate and fishflation flared anew. But unlike prior outbreaks, this new variety spiraled out of control.

Soon official fish got so small that they had to be bundled in packages of 50, then 100. Islanders were eating 200 fish a day just to stay alive. Any savings in Fish Reserve Notes became essentially worthless. The condition became known as hyper fishflation.



With fewer products coming in from Sinopia, Usonian retailers were left with diminished inventories. The result of skimpier fish chasing fewer products was soaring prices!

Through a rowdy public campaign, the senators attacked retailers for "price gouging." They claimed that fishflation could be stopped if the greedy businesspeople would agree to price controls on products and services. But as these measures focused only on the symptoms of fishflation, rather than the cause, they just made matters worse. Limiting what could be charged for a product without doing anything to control the decreasing value of money simply meant that manufacturers and retailers couldn't make a profit. As a result, they stopped selling and a black market of illegally high-priced merchandise arose.



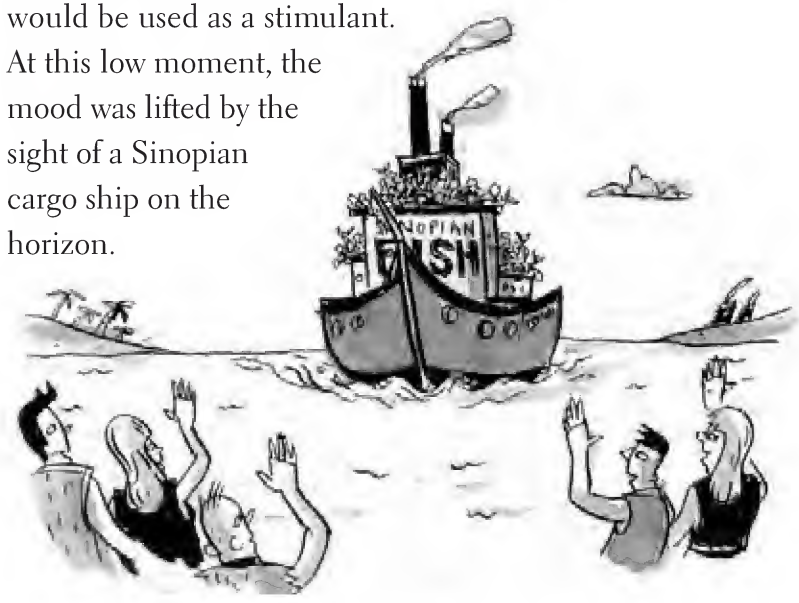
Sensing the trouble with Fish Reserve Notes, some citizens tried to protect the value of their remaining savings by depositing fish in an offshore bank, where their savings would be protected from senatorial slicing and dicing.

But when the senators noticed this trend, they made it illegal to move savings off the island.



The fear of shrinking fish became so prevalent that no deposits were left in the bank for long. Every fish caught was immediately sliced up and consumed. As had been the case before their economy grew, there were once again no savings, no credit, and no investment.

Unable to come up with any ideas, the senators did what they always did…they discussed plans for the next stimulus. Clearly, the prior attempts to shock the economy back to life were simply too small. The next round would just have to be bigger! However, no one was quite sure what would be used as a stimulant. At this low moment, the mood was lifted by the sight of a Sinopian cargo ship on the horizon.



The senators were thrilled. They assured their fellow islanders that the Sinopians must have seen the errors of their misguided abandonment of Fish Reserve Notes. They would once again be making deposits at the Fish Reserve Bank.

But when the Sinopian ship made port, something entirely different ensued.

Sinopian agents fanned out across the island with wheelbarrows of real fish, and cartloads of Fish Reserve Notes, buying everything, even the stuff that was nailed down. Since no one on Usonia had any real fish anymore, the Sinopians could outbid everybody on everything.



They bought the Water Works, dismantled it, and put it in a cargo canoe. They did the same with the lighthouses. They bought all the donkey carts, surfboards, hand nets, used bongos and even the mega fish catchers. For good measure they snapped up the empty condos so that Sinopian workers could have their own vacation huts.

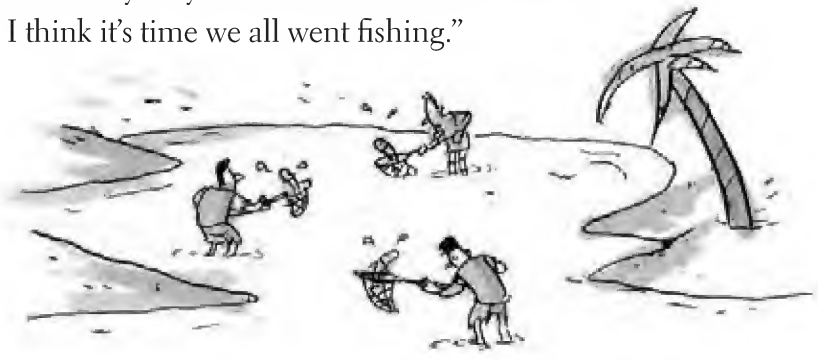


When their shopping spree was done the Sinopians left, bringing everything of value with them. They left behind the Fish Reserve Notes that they had accumulated over the years. At least, the Usonians would have plenty of kindling for their cooking fires. Finding something to eat was a different matter.

The senators surveyed the devastation and wondered where it had gone wrong. They had spent, so why hadn't the economy grown? Finally it became clear. It was all much simpler than what they had thought.

Addressing an anxious population still looking for answers, Senator Ocuda uttered the most honest words any politician could muster:

"Does anybody here remember how to make a net?
I think it's time we all went fishing."





TAKEAWAY

Throughout history, governments have gotten themselves into trouble by spending more than they have. When the gaps become too big, difficult choices arise.

One option is for the government to increase revenue by raising taxes. This path is never popular with citizens, and in a democracy is hard to push through. Even in authoritarian states (where there are no pesky elections), tax increases are problematic. Higher rates always discourage productivity and deflate economic vitality. There is a limit to how high taxes can go. Raise them enough, and people stop working. Raise them higher, and they may even start rioting.

A far better option is to cut government spending. However, this is often more difficult than raising taxes. Those whose benefits are cut are particularly apt to express their hostility both at the polls and on the street. This is especially true when the recipients feel entitled to the benefits. Politicians make lots of promises to secure their elections and voters rarely consider the ability of taxpayers to actually foot the bills.

To avoid either of these politically unpopular options, some governments choose to default instead. In this option a country simply tells its creditors that it can't pay the full amount of its debt obligations. If the debt is largely owed to foreigners, the decision is that much easier to make. Politically speaking, it is better to stiff a foreigner than to raise taxes on, or deny benefits to, a country's own citizens.

For political leaders, default can be rather embarrassing, as it amounts to an official acknowledgment of insolvency. To avoid this, many opt to simply print money to pay debts, effectively repudiating their obligations by inflating them away. Since inflation is usually the easiest choice to make, it is often the most likely. But while it may seem easy at first, it ultimately exacts the harshest toll.

Inflation allows governments to avoid hard choices and dispose of their debt on the sly. By printing money governments can nominally pay back all that they owe, but they do so by diluting their currency. Creditors get paid, but what they get isn't worth much, and if inflation turns into hyperinflation, it's worth nothing.

Inflation is simply a means to transfer wealth from anyone who has savings in a particular currency to anyone who has debt in the same currency. With hyperinflation, the value of savings gets completely wiped out and the burden of debt is removed. (Those who own hard assets do okay, because, unlike savings in currency, assets will rise in nominal value when inflation flares up.)

It has happened many times before: France in the 1790s, the Confederate States of America in the 1860s, Germany in the 1920s, Hungary in the 1940s, Argentina and Brazil in the 1970s and 1980s, and Zimbabwe today. In all of these instances the circumstances that led up to the hyperinflation, and the economic devastation that followed, were remarkably similar. The countries satisfied staggering debt by wiping out the value of their currencies. As a result, their own populations were thrown into abject poverty.

The United States today would certainly be the largest and most advanced economy to ever experience hyperinflation. But that doesn't mean that it can't happen. Thus far our ace in the hole has been the reserve status of the U.S. dollar. This means that the dollar will continue to be widely accepted no matter how bad the fundamentals get. But if we lose reserve status, our currency would be just as vulnerable as those that went down before.

We must look at these possibilities and head them off now, before we no longer have the ability to decide for ourselves.

EPILOGUE

The sorry outcome seen by Usonia in this tale need not be the fate ultimately encountered by that much larger island, the United States of America. Unfortunately, the longer our leaders pursue ever larger doses of the identical policies that were responsible for the financial crisis in the first place, the greater that eventuality becomes.

Although the idea of government stimuli as an antidote to the apparent failures of capitalism was born with Keynes, and nurtured with Roosevelt, it wasn't until Alan Greenspan, George Bush, Ben Bernanke, and Barack Obama that the idea really came into its own. Before 2002, we had never seen federal deficits of this magnitude (now exceeding $1.5 trillion annually), and we had never experimented so radically with ultra low interest rates and manipulation of credit markets.

The mistakes have been so simple, and yet we continue to make them.

In 2002, following the malinvestments of the dot-com era, when billions of dollars were poured into utterly hopeless companies, the economy entered what should have been a protracted downturn. But George Bush, then newly elected, didn't want a bad economy to jeopardize his reelection. So he, and his advisors, dialed up the Keynesian remedies

of spending and easy money to an extent not seen for generations.

As a result, the recession of 2002–2003 was one of the shallowest contractions on record. But that benefit came with a heavy long-term cost. The United States ended that recession with greater imbalances than it had before the downturn began. That's not supposed to happen.

Instead of real growth, we kicked off an even bigger asset bubble (in housing) that temporarily overcame the drag of the busted technology bubble. The rising value of housing prices created a great many 'benefits' that masqueraded as economic health. But as we have seen, that vigor was illusory.

The real tragedy is that six years later, when the next crash came, we had failed to learn anything from these mistakes. In diagnosing the causes and prescribing the best cures for the recession of 2008, economists and politicians are getting it dangerously wrong.

In the months since the financial world imploded, a consensus emerged that a lack of adequate regulations brought on the crisis. The roles of government and the Federal Reserve in particular have been largely ignored. As a result, we are getting more of what we don't need (spending and restrictive regulations) and less of what we do (savings and free enterprise).

Wall Street leaders were also irresponsible. The profits made by the big banks during the boom years were obscene. After the crash they should have paid far more dearly than they have. But bankers were playing the distorted hand dealt them by

government. Our leaders irrationally promoted home-buying, discouraged savings, and recklessly encouraged borrowing and lending, which together undermined our markets.

Policies enacted by the Federal Reserve, the Federal Housing Administration, Fannie Mae, and Freddie Mac (which were always government entities in disguise), and others created advantages for home buying and selling and removed disincentives for lending and borrowing. The result was a credit and real estate bubble that could only grow—until it could grow no more.

Artificially low interest rates (which made the economy appear healthy) invigorated the market for adjustable-rate mortgages and gave birth to the teaser rate, which made overpriced homes seam affordable. Alan Greenspan himself actively encouraged home buyers to partake. Then government agencies and government-sponsored entities compounded the problem by guaranteeing adjustable-rate mortgages based solely on the ability of borrowers to afford the teaser rates. Without such guarantees most of these mortgages never would have been funded.

Just as prices in a free market are set by supply and demand, financial and real estate markets are governed by the opposing tension between greed and fear. But government has done all that it can to remove fear from the equation.

And so beginning in 2008, as market forces moved to deflate the credit and housing bubbles, the government stepped in to re-inflate both. First came bailouts for Bear Stearns and American International Group (AIG) and guarantees for

other Wall Street firms such as Goldman Sachs and Bank of America. Then came Treasury's $700 billion Troubled Asset Relief Program (TARP) to purchase mortgage assets that no one in the private sector would touch. Then the government bailed out student loan provider Sallie Mae and essentially took over the entire student loan market. Bailouts for Detroit automakers soon followed.

Banks and businesses that should have failed were propped up by government support. Capital and labor that should have been freed up to find more productive uses were instead calcified in unneeded activities.

As consumers logically stopped spending after the housing boom deprived them of easy money, the government stepped in with a massive $700 billion stimulus in order to keep the registers ringing. This spending, which the government has borrowed from future generations, has kept us from the pain of living within our means.

By refusing to allow market forces to rein in excess spending, liquidate bad investments, replenish depleted savings, fund capital investment, and help workers transition from the service sector to the manufacturing sector, the government has resisted the cure while exacerbating the disease. In the process, we have turned just about all forms of debt into government debt, and have blown up another bubble, this time in Treasury bonds.

Unfortunately, this bubble threatens to dwarf all preceding asset bubbles. Its eventual bursting, which will cause consumer prices and interest rates to soar, will have even

more devastating effects on the economy than the dot-com and housing bubbles combined.

But there is time to stop the train before it heads off the cliff. We need leaders who have the courage to be honest with voters, and voters who have the strength to accept the hard work of economic renewal.

For years we have been living beyond our means, and we must summon the resolve to finally live within them. If we can do that, and allow free market forces to operate unhindered, we can rebalance our economy and set the stage for a real expansion.

However, if we choose to put our faith in debt, the printing press, and the promise of pain-free government solutions, we will all be fishing without a net.

ACKNOWLEDGMENTS

The central allegorical model of this book is borrowed from *How an Economy Grows and Why It Doesn't*, published in 1985, by Irwin A. Schiff, who generously bequeathed the idea to his offspring.

The authors also wish to thank the contributions of Brendan Leach who was able to illustrate quickly and creatively and give visual dimension to our sense of humor; and the staff at John Wiley & Sons, particularly Kelly O'Connor, whose help was vital in putting this material together in a coherent and entertaining package. We also would like to thank Mike Finger at Euro Pacific Capital who provided much philosophical and aesthetic feedback. Lastly we should thank all of those who have supported Irwin over the years with their thoughts and letters. It means a lot to him.

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PETER D. SCHIFF is the bestselling author of *Crash Proof 2.0: How to Profit from the Economic Collapse* and *The Little Book of Bull Moves in Bear Markets*. This is his first collaboration with his brother **ANDREW J. SCHIFF**, a recognized expert in economic and financial communications.

COVER DESIGN: PAUL McCARTHY • COVER ILLUSTRATIONS: BRENDAN LEACH

$19.95 USA / $29.95 CAN

ISBN 978-0-470-52670-5

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